



NORTH CAROLINA
RAILROAD
C O M P A N Y

FAST FORWARD



NORTH CAROLINA
RAILROAD
C O M P A N Y

2005 Annual Report

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FAST FORWARD

2005 Annual Report

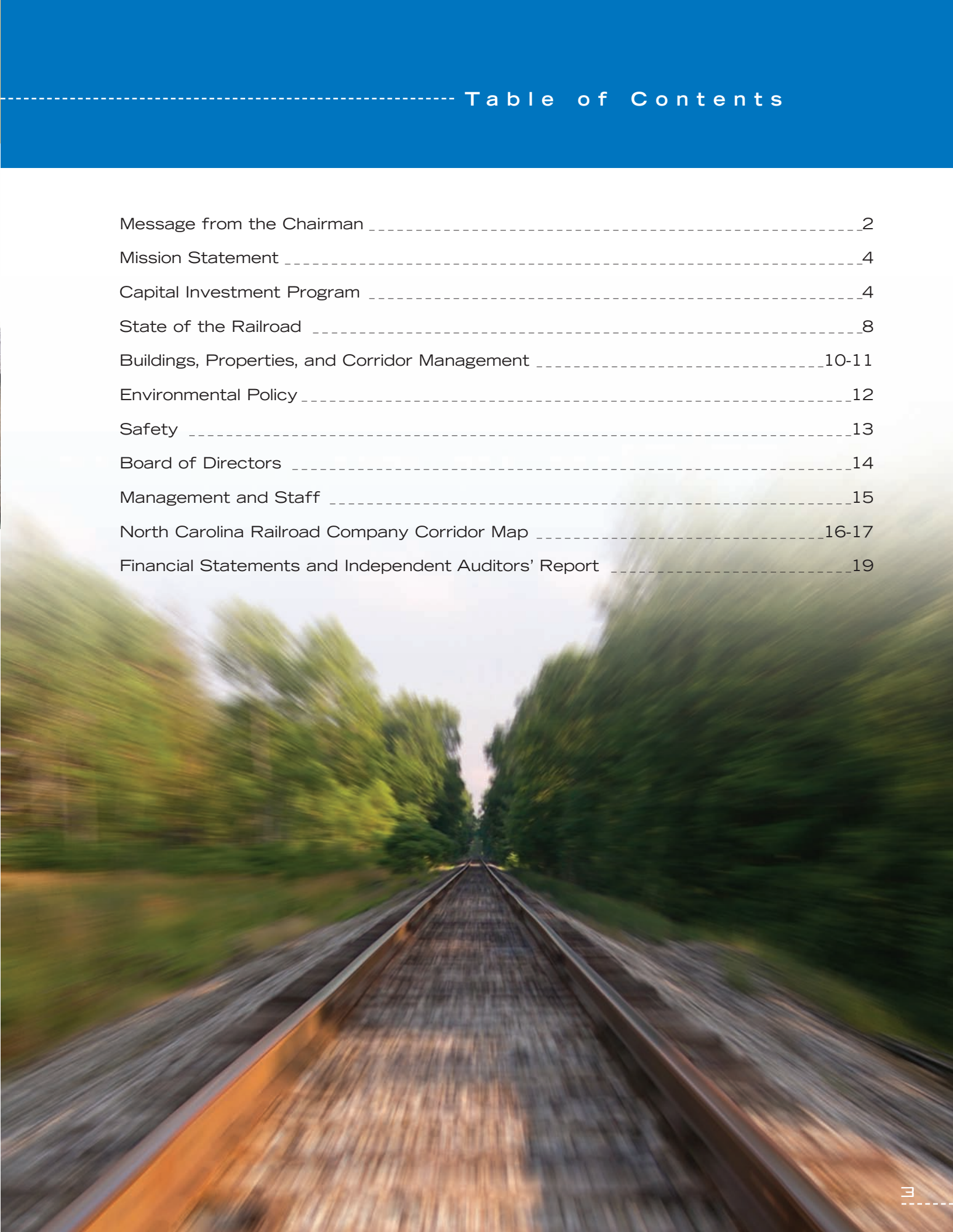
For five years now the North Carolina Railroad Company's (NCRR) Capital Improvement Plan has been in place. The goal of the plan, like the mission of the Company, is to build a better railroad. The Capital Improvement Plan has provided a blueprint for projects such as the installation of continuous welded rail and the construction of a new bridge over the Neuse River; both already finished. The completion of the railroad bridge over Highway 54 in Research Triangle Park and the announcement of a study of the feasibility of relocating the railroad tracks in Craven and Carteret Counties were two of NCRR's new projects in 2005. The construction of three sidings and signals between Raleigh and Goldsboro and the renovation of a bridge in Johnston County are two of the projects we're working on in 2006.

This year NCRR developed a Corridor Management Program to protect the railroad's footprint for future expansion of service, while developing ways to address buildings and other encroachments. As a part of this program we created a new tool for mapping the NCRR so we can clearly designate corridor boundaries and make corridor information available to planners, surveyors and others.

With projections for rail use at an all time high, NCRR proves its worth as one of the state's most valuable transportation assets. As the state's only source of dedicated funding for rail improvements, NCRR continues to choose projects that increase the railroad's ability to serve the industries, businesses and communities of North Carolina. In turn, these businesses create and expand job opportunities in a variety of fields. Please contact us with any questions or comments as we pursue our responsibility to build a better railroad for the people of the state.



William H. Kincheloe
Chairman of the Board of Directors
North Carolina Railroad Company



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The Mission

of the North Carolina Railroad Company

To manage, improve and protect the State of North Carolina's rail properties and corridors in a manner that will enhance passenger and freight service and promote economic development.

Capital Investment Program 2005-2012

Improving the railroad for freight and passenger service drives the selection of projects for NCRR's Capital Investment Program.

The strength of the state's rail transportation infrastructure depends on the quality of rail, the width and height of bridges, the technology in signaling equipment and the capacity of the corridor to serve increasing demands for more trains. NCRR works with the North Carolina Department of Transportation, Norfolk Southern Railway and the communities through which it extends to select those projects that will have the most beneficial impact on the state's economy. Here is a Summary Status of NCRR projects through 2012.



Bridges

NC 54 Bridge-Research Triangle Park

A narrow, outdated bridge was replaced with a double-track structure that will accommodate regional transit needs, increase rail capacity, improve vehicular traffic flow and eliminate substandard clearance. NCRR's portion of the project is complete, and on budget.

Cost: \$5,500,000

Restricted Bridge-Clayton

Upgrading this structure eliminates speed restrictions and improves clearance on Highway 70 Business. The present bridge has been damaged by trucks striking its girders.

Status: Future

Restricted Bridge-near Burlington

The existing bridge over Highway 87 is restricted for double-stack loads.

Status: Under design

Bridge Trestle-Craven County

A single-track wooden trestle in Craven County needs replacement to accommodate today's wider, faster, heavier rail cars and to improve access to the port.

Cost: \$300,000

Status: Construction in progress

Neuse River Bridge-Johnston County

This 80-year old bridge requires repair and renovations.

Its 306-foot through truss span is height restricted. Work will improve clearance.

Status: Under design

Bridge and Grade Separation-Charlotte

Both vehicular and train traffic would flow more smoothly with improvements to the busy Sugar Creek Road area in Charlotte. With heavy freight and passenger train service, this part of the line is under evaluation. The project would be done jointly.

Cost: \$13,000,000

Status: Evaluation and Study by NCRR, NCDOT, and Charlotte DOT.



Several bridges are outdated, with height and weight limitations.



This is a welded rail train unloading "strings" of rail to replace older, lighter weight rail between Goldsboro and New Bern.



An Amtrak train crosses the newly completed NCR rail bridge over Highway 54 in Research Triangle Park. NCDOT will soon widen the road to five lanes as a result.

Track Improvements

Double Track, Siding, Signal — Raleigh to Goldsboro

Three new passing tracks totaling 8 miles will improve performance and safety with enhanced speed and capacity to accommodate growth for both freight and passenger service. Additional work includes a passing siding in Wake County, and Centralized Traffic Control to raise this segment to the standard of the Raleigh-Charlotte mainline.

Cost: \$20,700,000

Status: In Progress

Double Track — High Point to Greensboro

A second main track between Cox and Hoskins will improve capacity and ease delays caused by meeting or passing trains on the mainline.

This is one of the most congested sections on the railroad.

Cost: NCRR \$4,000,000, (NCDOT \$15,000,000 contribution)

Status: In Progress

Replace 90 lb. Rail — Goldsboro to New Bern

The existing rail's lighter weight makes it inadequate for the 110 and 125 ton cars now operating on the track. There are three segments, totaling 15.5 miles. This is a joint project with Norfolk Southern.

NCRR Cost: \$5.5

Status: To be completed in 2006

Curve Straightening — Hopson Road

NCRR is acquiring property adjacent to the track to allow straightening of a curve east of the NC Highway 54 bridge. Project will increase speed for passenger and freight trains. Land acquisition is nearly complete.



New signals allow more trains to use the tracks, improving capacity and safety.



Specialized equipment and skilled workers are brought in to complete track improvement projects on the railroad.



A Track Relocation Study is underway in Morehead City to see if the tracks can be relocated out of the middle of town.

Economic Development

Storage Yard Relocation — Raleigh

Relocating the storage yard eastward would improve property in urban areas, increase parking and safety of the Amtrak station, and allow through trains on NCRR to/from New Bern and the Port at Morehead City.

This project will improve speed and efficiency of trains and increases safety around tracks and use of real property. Plans call for partnering with Norfolk Southern Railway. Estimated cost is \$23 million.

Track Relocation Study — Morehead City

A feasibility study will determine if there is a better alternate route for the railroad in Craven and Carteret County that could open the eastern part of the state for rail-served industry locations. Improved service to the Port at Morehead City and freer vehicular flow in the counties are potential benefits. A consulting firm has been selected and the study will be completed in 2007.

Construction of Three Pedestrian Underpasses

Pedestrian underpasses are in design for areas with significant pedestrian traffic. A preliminary design is complete for an underpass in Elon, Jamestown is under study, and a third location is being determined.



An Amtrak train crosses the Highway 54 bridge as workers finish coating the structure.



A Norfolk Southern freight train passes over the Neuse River bridge, the first NCRR bridge completed through the Capital Improvement Program.



More than \$50 million has been invested to improve freight rail service east of Raleigh and to the Port at Morehead City.

“North Carolina occupies a key position in Norfolk Southern’s rail network, hosting more than 1,400 route miles that link us to important domestic and international markets. The North Carolina Railroad serves as our key east-west corridor in the state, keeping us connected with numerous customers. We look forward to many years of partnership with NCRR.” --Wick Moorman, President and CEO, Norfolk Southern Corporation

The past year was a banner one for freight railroads with record-breaking carload counts and revenue figures posted nationwide. Norfolk Southern Railway, the freight operator for the NCRR, was no exception. System wide, NS carloadings were up 4.3% and revenues up 16.6%. Their biggest commodity was coal (\$2.1 billion), followed by intermodal (\$1.8 billion), automotive (\$997 million), metals and construction (\$978 million), chemicals (\$973 million), agriculture and consumer products (\$834 million) and paper and forest products (\$793 million). In 2005, NS attracted 78 new industries and 43 plant expansions –industrial development efforts estimated at \$2 billion. Here in North Carolina, NS generated business on both the part of the NCRR that serves as its mainline, and on the eastern part of the railroad, where NS operates its East Carolina Business Unit.

Industrial Development Update:

Imaflex USA—Thomasville, NC

This Canadian-based packing company signed a long term lease for expansion. They receive plastic resin by rail to make plastic packaging, approximately 300 carloads per year.

84 Lumber Company—High Point, NC

Purchased this rail served site for a retail/wholesale lumber operation with approximately 100 carloads per year.

EAST CAROLINA BUSINESS UNIT UPDATE: For 2005, carloads were slightly down at 67,032 compared to 67,803 in 2004 (-1.2%). ECBU was able to maintain car levels with new business and/or relocated business, as in the case of the port. ECBU performance exceeded the prior years due to NCRR upgrades on the railroad in eastern North Carolina. The key customers seeing changes were as follows:

The Port of Morehead City

Inbound/outbound carloads were 4,202 compared to 3,407 in 2004. This moderate growth occurred despite losing the PCS export fertilizer. Increase is attributed to new steel users at the port as well as lumber being shifted from Wilmington to MHC.

Progress Energy

Demand for coal at the Lee Plant in Goldsboro increased from 6,860 to 9,193 carloads.

Case Farms – Radford

Rail shipments increased from 122 to 681 carloads, regaining business.

Cargill – Raleigh

Carloads increased from 4,164 to 4,692 carloads.

Buildings, Properties, & Corridor Management

The Rail Corridor

The 317-mile rail corridor stretching from Charlotte to the Port at Morehead City is the principal asset of the NCRR. Being two hundred feet wide for nearly its entire length, this ribbon of real estate, consisting of more than 7,600 acres, presents unique challenges to effective property management. Public streets and roadways count as the No. 1 encroachment, and working with the NCDOT and local municipalities to control expansion of roadways in and around the corridor to provide for future growth of rail traffic is critical. Hundreds of commercial and industrial businesses that adjoin the over 630 miles of boundary line present a significant challenge to monitoring what activities exist along the rail corridor, and regulating what goes on within the corridor. The NCRR Real Estate Department instituted an aggressive Corridor Management Program in 2005 that includes meeting with those that occupy portions of the rail corridor and working with them to assure that their activities are appropriate for the nature of the primary corridor use as a railroad. Securing agreements with those utilizing the corridor for commercial purposes provides revenues to cover the cost of managing the corridor, but the real value is the protection afforded the corridor to assure it is viable for the next 150 years.

In addition, the NCRR is working closely with the small towns and large cities along the corridor to assure that those involved with planning for the future growth of North Carolina recognize that the rail corridor, an invaluable asset of the State, is protected for future generations.

NCRR's Geographic Information System

Managing and understanding the past, current and future uses of the corridor require the latest technology. NCRR is now nearing full implementation of its Geographic Information System (GIS). This system will utilize computer generated maps to graphically record each documented and undocumented use of the corridor, enabling its efficient and cost-effective management.

This technology manages, analyzes, and disseminates geographic data, or maps, by incorporating "layers" of data. To date NCRR has concentrated on the overall design and structure of the GIS to incorporate more than 150 years of legacy data and maps. The earliest of the legacy data are surveys that were performed during the original construction of the rail line in 1851.



NCRR helped a Havelock Historic Preservation Association relocate this depot to a more suitable location off the rail corridor.



Property Representatives Cathy Deeley and John Spencer work closely with GIS Coordinator Kristian Forslin to produce accurate information about NCRR corridor boundaries.



Taking GIS measurements to accurately map the corridor.

This survey layer, when coupled with high resolution aerial photography obtained in 2005, creates base mapping for presenting corridor boundary line information. Additional land purchases and sales from 150 years of track upgrades and improvements are now being incorporated to show the ownership as it exists today.



This newly acquired base map and accurate representation of the corridor has allowed NCRR to create the framework for new map layers, such as land and utility occupancies by third parties. Each feature in each layer is linked to a position on the map and is recorded in a database describing that particular feature. This link generates relationships between otherwise disparate data on the basis of common geography, revealing hidden patterns and trends that are not readily apparent in spreadsheets or flat file maps. This GIS digitally catalogs and analyzes NCRR's property and assets as they relate to their surroundings and NCRR's mission. The GIS has already provided efficiencies and greater understanding of the management of the corridor.

Other Properties

The NCRR owns numerous buildings along the corridor that are currently or were formerly used in the operation of the railroad. Some buildings found to no longer be needed in rail operations still have many years of productive use. With local involvement and local investment, several have been adaptively rehabilitated for commercial uses that provide income to the NCRR to further fund corridor projects and economic development. The NCRR is working with the City of New Bern to find a productive use of the former passenger depot located on the corridor, and the City of Lexington is in the planning stages of adapting the former freight depot in that town for a farmers market and maybe a future passenger rail station.

Land owned by the NCRR along the corridor once used in rail operations often is of interest to industrial users and some sizeable parcels of land have potential to be used to attract new industries to the State as a key part of the NCRR mission to promote economic development. For the year ending in 2005, NCRR purchased a 0.11 ac. parcel adjacent to the NCRR rail corridor from Amerigas Propane, L.P. on March 22, 2005, for \$22,000 in Alamance County for use in locating a future industrial side track.

The NCRR completed an exchange of land with the Town of Gibsonville on September 21, 2005. The Town received a 1.74 acre parcel that was the site of the former Gibsonville Depot, now a town square used by the Town. The Town acquired and exchanged the Town Square property with NCRR for a 2.245 acre parcel just east of Gibsonville, Alamance County. Both properties were valued at \$30,000.

Three leases were entered into by the NCRR in 2005:

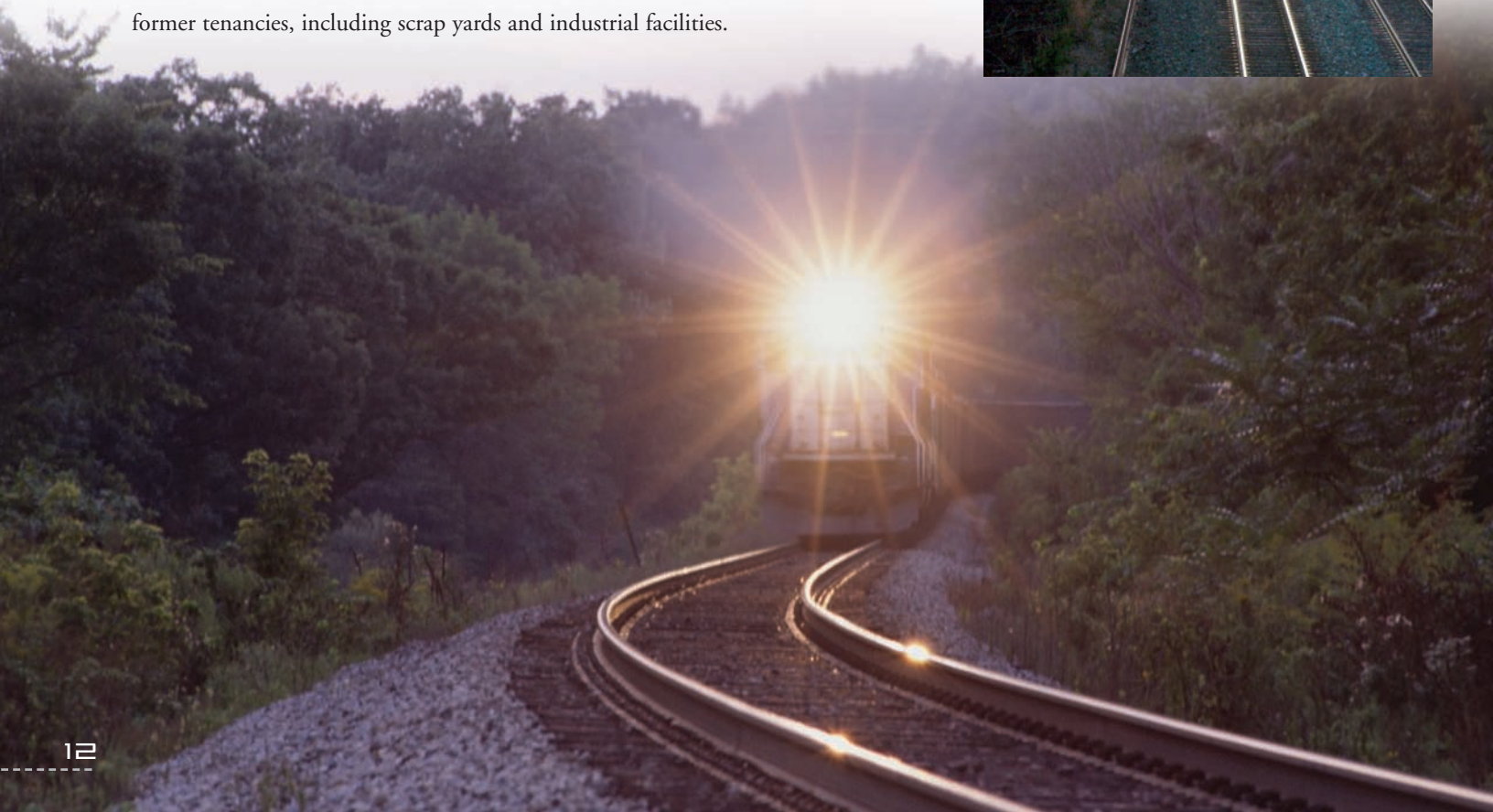
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| The former Durham Depot property in Durham County was leased to McLaurin Parking Company for a term of three years for use as a parking lot. | The State Employees Credit Union leased a portion of the parking lot at the Burlington Engine House, Alamance County, for locating an ATM. The lease term is three years. | NV, LLC, leased 3,793 s.f. of The Raleigh Depot in Raleigh, Wake County. The lease term is five years. |
|--|---|--|

Environmental Policy

NCRR, Norfolk Southern and NCRR's other licensees are responsible for compliance with state, federal, local laws or other provisions relating to the discharge of materials and the protection of the environment. The risk of incurring environmental liability is inherent to conducting railroad operations. Some of the commodities that are transported over the railroad lines are classified as hazardous materials. Environmental problems may exist on properties owned by the railroad which are known by the encroachers or former tenants but which have not been disclosed to the NCRR. State and federal environmental provisions may impose joint and several liability upon the railroad and its lessees and sub-lessees for environmental damage or clean up (or associated costs) of any real properties owned by the railroad and adjoining properties if the source of any problem is the property of NCRR. NCRR believes that damage or clean up (or associated costs) is the responsibility of the lessees and any sub-lessees or other parties who may have created any actionable environmental condition.

The 1999 Trackage Rights Agreement with Norfolk Southern contains extensive provisions governing the rights and obligations of the parties for various environmental liabilities and expenses.

NCRR has conducted most of the Phase I Environmental assessments required under the 1999 Trackage Rights Agreement with Norfolk Southern. Several of the assessments indicate the possibility of environmental contamination and will need further attention. These problems include underground storage tanks and remnants of former tenancies, including scrap yards and industrial facilities.



Safety

Nationally, the Association of American Railroads and the Federal Railroad Administration report that preliminary figures proclaim 2005 as the safest rail-year ever. Rail employee injury rate was down 12.7% and train accidents were down almost 8%. The grade crossing incident rate fell 4.2 % from 2004, and the number of grade crossing accidents and fatalities fell 1.9% and 3.5%, respectively.

Locally in North Carolina, there were 8 fatalities and 44 injuries in 66 collisions between trains and vehicles. The state had 22 fatalities and 11 injuries in trespassing incidents.

In 2005, along with North Carolina Operation Lifesaver, NCRR co-sponsored two safety trains. These special trains, supplied by NS, are outfitted with video cameras so passengers can see how drivers sometimes try to beat the train at crossings, fail to stop for signals, and occasionally drive around gates. Members of the press, public safety officials, and elected and community officials are invited for the ride. Volunteers from Operation Lifesaver explain the need for heightened awareness of safety around trains. This year's trips were from Raleigh to Greensboro and from Goldsboro to New Bern. The latter trip was especially relevant when a tractor trailer failed to stop at a crossing, causing a collision between truck and train. Additionally, NCRR works with NS and NCDOT to close redundant grade crossings, with the involvement and support of local communities.



This Operation Lifesaver train ran from Goldsboro to New Bern, carrying media, public safety officials and community leaders interested in rail safety issues.



NCRR's CFO and Vice President Dan Halloran (left) on a safety train that operated between Raleigh and Greensboro.

North Carolina Railroad Company Officers and Directors

William H. Kincheloe, Chairman
Rocky Mount
President, Wildwood Lamps and Accents

David T. Woodard, Secretary & Treasurer
Raleigh
General Agent for Union Central Financial

Directors

John S. Arrowood
Charlotte
Partner, James, McElroy & Diehl PA

Sam Hunt
Burlington
Owner, Hunt Electric Supply and Atlas Lighting Products, Inc.

John L. Atkins, III
Durham
President and Chief Operating Officer, O'Brien/Atkins Associates PA

Jack A. Moody
Siler City
Retired Attorney, Veteran US Navy and US Marine Corps

Robert F. Bleecker
Red Springs
President of Bleecker Olds, Buick, GMC, Inc. and Bleecker GMC Trucks and Superstore

John M. Pike
Goldsboro
Director of Operations, Goldsboro Milling Corporation

Christie S. Cameron
Raleigh
Clerk of the North Carolina Supreme Court

Frederick Kenneth Ruffin
Durham
Owner Ruffin Realty and Insurance, Inc. (retired)
US Air Force (retired)

Murray C. Greason, Jr.
Winston Salem
Member, Womble Carlyle Sandridge & Rice

J. Bradley Wilson, Immediate Past Chairman
Durham
Executive Vice President, Chief Administrative Officer and Corporate Secretary, Blue Cross and Blue Shield of N.C.

Robert W. Griffin
Kinston
Principal in the law firm of Griffin and Griffin, Attorneys

Committees of the Board

Executive
William Kincheloe, Chair
Robert F. Bleecker
Christie Cameron
Murray Greason
Scott M. Saylor
David T. Woodard

Audit
Murray Greason, Chair
John Atkins
John Arrowood
Christie Cameron
Robert Griffin
David T. Woodard

Property Management
Robert Bleecker, Chair
John Pike, Vice Chair
John Atkins
Sam Hunt
Jack Moody
Frederick Ruffin
David T. Woodard

Policy Planning
Christie Cameron, Chair
William Kincheloe, Vice Chair
John Arrowood
Murray Greason
Robert Griffin
John Pike
David T. Woodard

Officers & Management

Scott M. Saylor, President
Kat Christian, Public Affairs Director
Kathy Daniels, Executive Assistant

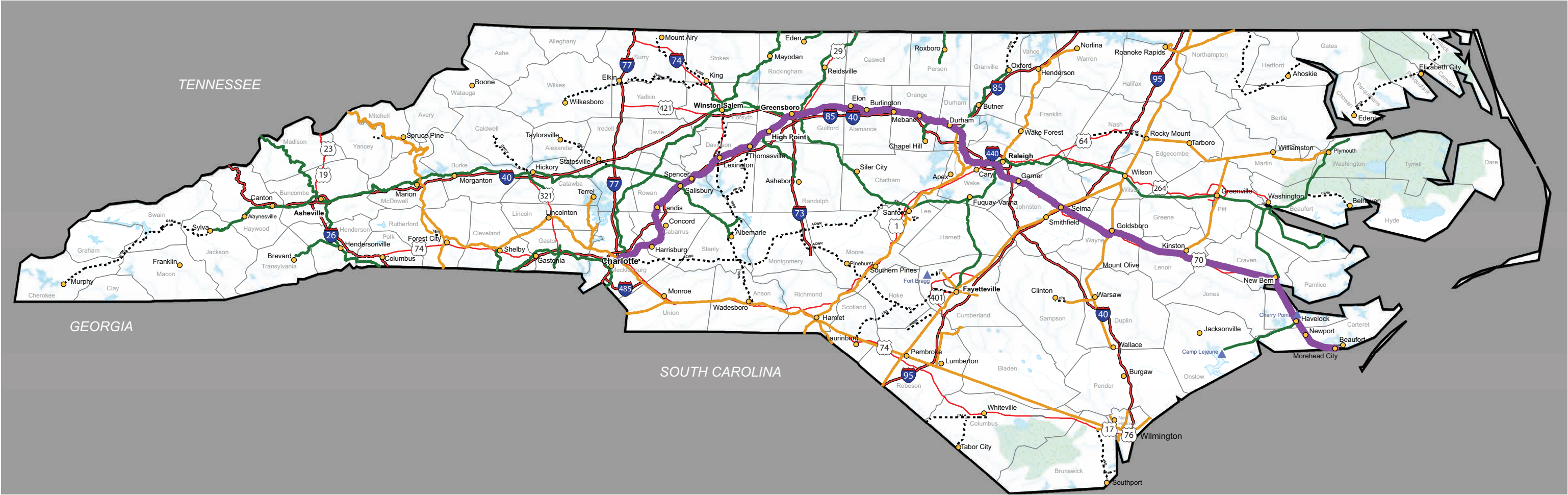
Property Department

Charles E. Burnell, Assistant Vice President, Real Estate
William C. Miller, Property Manager
Justin Madigan, Assistant Corridor Manager and Information Technology
Keri Petersen, Archivist/Records Management
Carol Jackson, Contract Administrator
John L. Spencer, Real Estate Representative
Cathy J. Deeley, Real Estate Representative
Kristian D. Forslin, GIS Coordinator





Accounting and Capital Budgeting

Dan Halloran, Vice President and Chief Financial Officer
Nancy Pickett, Office Manager
Glenn E. Hartsoe, P.E. Consulting Engineer





NORTH CAROLINA
RAILROAD
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-  North Carolina Railroad Company
-  Norfolk Southern
-  CSX Transportation
-  Various Short Lines

NORTH CAROLINA RAILROAD COMPANY

December 31, 2005 and 2004

INDEPENDENT AUDITORS' REPORT

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INDEPENDENT AUDITORS' REPORT

To the Shareholders and Board of Directors,
North Carolina Railroad Company

We have audited the accompanying balance sheets of North Carolina Railroad Company as of December 31, 2005 and 2004, and the related statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of North Carolina Railroad Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Reznick Group, P.C.

Charlotte, North Carolina
April 1, 2006

BALANCE SHEETS December 31, 2005 and 2004

Assets

	2005	2004
Current assets:		
Cash and cash equivalents <i>(see Note 3 for descriptions of obligations requiring the use of cash)</i>	\$ 1,435,311	\$ 2,515,604
Restricted cash	939	18,594
Accounts receivable	360,065	668,249
Prepaid expenses	31,544	48,879
Total current assets	1,827,859	3,249,326
Property and equipment:		
Roadway and land	7,848,742	7,848,742
Tracks, signals and bridges	15,624,983	6,515,923
Land	4,236,913	4,115,640
Buildings and improvements	6,084,443	6,059,443
Equipment and furniture	947,172	422,006
Construction in progress	2,138,976	8,651,029
	36,881,229	33,612,783
Accumulated depreciation	(2,428,853)	(1,331,189)
Net property and equipment	34,452,376	32,281,594
Other assets:		
Funded capital projects	31,290,772	21,872,548
Deposits	10,010	10,000
Total other assets	31,300,782	21,882,548
Total assets	\$ 67,581,017	\$ 57,413,468

BALANCE SHEETS (continued) December 31, 2005 and 2004

Liabilities and Shareholders' Equity

	2005	2004
Current liabilities:		
Accounts payable and accrued expenses	\$ 1,083,433	\$ 1,827,243
Long-term liabilities:		
Security deposits	67,931	2,873
Total liabilities other than stock subject to mandatory redemption	1,151,364	1,830,116
Series B preferred stock subject to mandatory redemption	302,500	-
Total liabilities:	1,453,864	1,830,116
Shareholders' equity:		
Preferred stock, \$.01 par value, 105 series A shares issued and outstanding	-	1
Common stock, \$.50 par value, 10,000,000 shares authorized; 317 shares issued and outstanding	159	159
Additional paid-in-capital	115,831,832	105,461,149
Retained deficit	(49,704,838)	(49,877,957)
Total shareholders' equity	66,127,153	55,583,352
Total liabilities and shareholders' equity	\$ 67,581,017	\$ 57,413,468

see notes to financial statements

STATEMENTS OF OPERATIONS

Years ended December 31, 2005 and 2004

	2 0 0 5	2 0 0 4
Income:		
Lease of roadway and land	\$ 12,115,926	\$ 11,881,270
Other lease income	1,101,327	1,127,282
Interest and dividend income	895,855	330,084
Other income	1,054,278	97,873
Total income	15,167,386	13,436,509
Expenses:		
Wages and benefits	1,002,924	799,053
Professional fees	436,827	508,334
Contracted services	228,394	126,386
Reporting and public relations	137,075	118,361
Insurance	181,721	182,750
Franchise and property taxes	226,666	181,950
Depreciation	1,097,664	433,440
Repairs and maintenance	153,814	217,100
Engineering, surveying and mapping	166,679	47,896
Interest expense	132,613	-
General and administrative	557,690	338,352
Total expenses	4,322,067	2,953,622
Income before income taxes	10,845,319	10,482,887
Income tax expense	-	-
Net income	\$ 10,845,319	\$ 10,482,887

see notes to financial statements

STATEMENTS OF
SHAREHOLDERS' EQUITY

Years ended December 31, 2005 and 2004

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Deficit	Shareholders' Equity
Balance as of January 1, 2004	\$ 1	\$ 159	\$ 95,474,045	\$ (50,322,644)	\$ 45,151,561
Dividends (common - \$31,600 per share)	-	-	-	(10,017,200)	(10,017,200)
Dividends (preferred - \$200 per share)	-	-	-	(21,000)	(21,000)
Redemption of common shares	-	-	(30,096)	-	(30,096)
Capital contribution related to capital improvement projects	-	-	10,017,200	-	10,017,200
Net income	-	-	-	10,482,887	10,482,887
Balance as of December 31, 2004	1	159	105,461,149	(49,877,957)	55,583,352
Dividends (common - \$33,600 per share)	-	-	-	(10,651,200)	(10,651,200)
Dividends (preferred - \$100 per share and series A redeemed - \$100 per share)	-	-	-	(21,000)	(21,000)
Redemption series A preferred shares	(1)	-	(262,499)	-	(262,500)
Redemption of common shares	-	-	(18,018)	-	(18,018)
Capital contribution related to capital improvement projects	-	-	10,651,200	-	10,651,200
Net income	-	-	-	10,845,319	10,845,319
Balance as of December 31, 2005	\$ -	\$ 159	\$ 115,831,832	\$ (49,704,838)	\$ 66,127,153

see notes to financial statements

STATEMENTS OF CASH FLOWS

Years ended December 31, 2005 and 2004

	2005	2004
Operating Activities		
Net Income	\$ 10,845,319	\$ 10,482,887
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	1,097,664	433,440
Changes in operating assets and liabilities:		
Accounts receivable	308,184	(586,655)
Income taxes recoverable	-	26,864
Prepaid expenses	15,335	1,715
Deposits	(10)	62,806
Accounts payable and accrued expenses	(388,043)	(12,961)
Security deposits	65,058	-
Net cash provided by operating activities	11,943,507	10,408,096
Investing Activities		
Purchases of property and equipment	(3,624,213)	(10,212,530)
Funded capital projects	(9,418,224)	414,607
Net cash used by investing activities	(13,042,437)	(9,797,923)
Financing Activities		
Payments of dividends	(10,672,200)	(10,038,200)
Additional paid in capital	10,651,200	10,017,200
Repurchase of stock	(280,518)	(30,096)
Issuance of redeemable preferred shares	302,500	-
Net cash provided by financing activities	982	(51,096)
Increase (decrease) in cash, cash equivalents and restricted cash	(1,097,948)	559,077
Cash, cash equivalents and restricted cash at beginning of year	2,534,198	1,975,121
Cash, cash equivalents and restricted cash at end of year	\$ 1,436,250	\$ 2,534,198

see notes to financial statements

NOTES TO FINANCIAL STATEMENTS

December 31, 2005 and 2004

NOTE 1 Significant Accounting Policies

Organization

The North Carolina Railroad Company (the Company or NCRR), owns approximately 317 miles of continuous railroad line extending from Charlotte, North Carolina to Morehead City, North Carolina. The Company’s railroad facilities are operated by Norfolk Southern Railway Company (NSR). Pursuant to a Merger Agreement dated January 16, 1998, the Company merged with the Beaufort & Morehead Railroad Company (B&M), a company wholly owned by the State of North Carolina. The merger was effective April 1, 1998. Upon consummation of the merger, the State became sole owner of all of the common stock of the Company. In connection with the acquisition, the Company issued 105 shares of series A callable preferred stock which require an 8 percent annual dividend, payable semi-annually.

Property and Equipment

Buildings and equipment are reported at cost. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. Buildings are depreciated over twenty-five years, land improvements are depreciated over ten years, track and signals are depreciated over ten years, bridges are depreciated over twenty-five years and furniture and equipment are depreciated over three to seven years. Values of the properties in the roadway and land account approximate 1916 valuations by the Interstate Commerce Commission. These properties are not depreciated because they represent fully depreciated roadway or non-depreciable land. However, a rehabilitation project of \$200,000 was amortized over a five-year period in the 1940’s.

Lease of Roadway and Land Revenue Recognition

Revenue is reflected in the statements of operations when earned in accordance with the Company’s lease arrangements on the accrual method.

Other Lease Income Recognition

The Company leases certain property that is not operated by NSR. Revenue is reflected in the statement of operations when earned. The Company also collects license fee revenue which is recognized when earned.

Income Taxes

The Company is a real estate investment trust (REIT) for federal income tax purposes. A corporate REIT is a legal entity that holds real estate interests and through distributions to shareholders is permitted to reduce or avoid the payment of federal and state income taxes at the corporate level. To maintain qualification as a REIT, the Company must distribute to shareholders at least 90 percent of REIT taxable income. The absence of a provision for current income taxes for 2005 and 2004 on the statements of operations is the result of deductible distributions of 100 percent of taxable income. There can be no assurance that the Company can continue to qualify for REIT status; however, the Company believes it will continue to qualify as a REIT for 2006.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

Cash and Cash Equivalents

Cash and cash equivalents include investments in commercial paper, U.S. Treasury Bills, and certificates of deposit with original maturities of three months or less. Cash deposits are placed with high credit quality financial institutions. At times, deposits exceed amounts insured by the Federal Deposit Insurance Corporation.

Restricted Cash

At December 31, 2005 and 2004, \$939 and \$18,594, respectively, of cash was reserved for payment to certain former common shareholders in connection with the 1998 merger. These amounts have been classified as Restricted Cash on the balance sheet.

Receivables

Management considers receivables to be fully collectible; accordingly, no allowance for doubtful accounts has been provided. If amounts become uncollectible, they are charged to operations in the period in which that determination is made.

Fair Value of Financial Instruments

The Company estimates that the fair value of all financial instruments approximates the carrying amounts. Because of the short-term maturity of cash equivalents, accounts receivable, accounts payable and accrued expenses, their carrying amounts approximate fair value.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain items from the prior year financial statements have been reclassified to conform to the current year presentation.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

NOTE 2 Trackage Rights Agreement and Leases On Roadway and Land

Prior to 1999, substantially all of the Company’s assets were leased to NSR or its predecessors, in two leases dating to 1895 and 1939. The terms of the leases did not require either the Company or Norfolk Southern to renew the leases.

On August 10, 1999, the Board of Directors of the Company approved a Trackage Rights Agreement (TRA) with NSR effective January 1, 2000, terminating the leases. The agreement term is 15 years with two 15-year renewal options by NSR (45 years) for a base rental of \$11,000,000 (minimum) beginning January 1, 2000, with annual adjustments based upon an inflation index and a 4 1/2 percent annual cap (arbitration of cap if it exceeds an average of 4 1/2 percent over any 7-year period). The TRA provides for transition of management of certain non-rail properties to the Company, maintenance of the Company’s rail property, inspections, records sharing, and audit. The TRA was approved by the Surface Transportation Board on September 1, 1999.

The TRA grants exclusive freight trackage rights to NSR to conduct all freight operations over the NCRR railroad line. Under federal law National Rail Passenger Corporation (Amtrak) operates over NSR operated lines under agreements with NSR. NSR is obligated under the TRA to provide rail service to all industries on the NCRR line and to dispatch rail operations on the NCRR line. NSR is obligated to maintain the NCRR line and any improvements made to the line by NSR for freight operations. Under the TRA, NSR does not have financial responsibility for passenger improvements made by the Company, North Carolina Department of Transportation (NCDOT), Amtrak, or other parties.

Approximately 40 parcels not used in railroad operations are being returned to the Company for separate (non-NSR) management. These non-corridor properties will be managed by the Company after transition from NSR management. Several thousand active and inactive corridor lease/license agreements have been transferred to the Company for administration or disposition. The TRA contains provisions for responsibility for environmental matters by NSR and the Company.

The TRA provides that NSR will cooperate in maintaining the Company’s REIT tax status. NSR is responsible for any taxes on its freight operations. A Policy Planning Committee comprised of NCRR and NSR representatives addresses all future planning issues, capital improvements, and any disputes that arise under the TRA. In the event of any disagreements, NCRR and NSR are subject to binding arbitration under the TRA.

A lease of certain properties in Charlotte, North Carolina to Norfolk Southern (the 1968 Lease) expires on December 31, 2067, and provides for an annual rental of \$81,319 through December 2017. Beginning on January 1, 2018, 6 percent of the appraised value of the property will be the annual rental for the remaining term of the 1968 Lease. Under the terms of the 1968 Lease, all taxes connected with the property, except income taxes, are paid by the lessee. The 1968 Lease was not affected by the TRA.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

NOTE 3 Capital Commitments

Capital Improvement Agreement

On March 20, 2002, the Company entered into a capital improvement agreement (the Capital Agreement) with NSR in order to establish an understanding between the parties about desired capital improvements as well as a means to fund individual projects pursuant to the TRA. The Capital Agreement calls for certain identified capital improvements to be made to the Company’s railroad line (the Projects). As of December 31, 2005, the Company’s share of the Projects total approximately \$88.8 million and are scheduled for completion between 2006 and 2012.

The Capital Agreement calls for the execution of individual project agreements as appropriate and contains certain provisions with regard to construction responsibilities and cost allocation. The Capital Agreement provides for the funding of a capital program escrow account with an initial deposit of \$500,000 by the Company and additional deposits of obligated Company capital improvement funds held pursuant to N.C. General Statute 124-5.1 to fund capital improvements as recommended and approved by the Company’s Board of Directors.

Capital Account Funds Agreement

On June 21, 2002, the Company and the NCDOT entered into a Capital Account Funds Agreement (CAFA) pursuant to N.C.G.S. 124-5.1. The agreement provides that the Company may request obligated NCRR REIT dividends to be expended for improvement of NCRR property as approved by the NCRR Board of Directors, and NCDOT is required to make a contribution to the capital of the Company on behalf of the State as shareholder in the amount requested by the Company. The funds are then restricted for use for approved capital improvement projects.

On December 5, 2002, the Board of Directors approved a resolution obligating capital funds for certain capital improvements, such as bridge replacement and rail upgrades. These projects are to be funded through the CAFA. On July 15, 2004 and May 19, 2005 the Board of Directors approved supplemental agreements to the CAFA with NCDOT in order to update the Capital Improvement Project List. The Company’s share of the capital improvements identified and approved through December 31,2005 total approximately \$88.8 million and are scheduled for completion between 2006 and 2012.

Projects completed under the Capital Agreement with NSR and the CAFA with NCDOT total approximately \$16.2 million as of December 31, 2005, including bridge replacement and rail relay projects.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

The Company has designated the following amounts to capital improvement projects:

	2005	2004
Restricted under construction contracts	\$ 17,991,100	\$ 5,251,953
Restricted under the CAFA	12,493,212	15,833,079
Restricted for other capital improvements	806,460	787,516
	<u>\$ 31,290,772</u>	<u>\$ 21,872,548</u>

Other Capital Improvements

Not included under the Capital Agreement or the Capital Account Funds Agreement is one redevelopment project. A 90 year old freight depot is currently undergoing rehabilitation, with costs incurred through December 31, 2005 of \$2.1 million included in construction in progress on the balance sheet.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

NOTE 4 Employee Benefit Plan

The Company sponsors a SEP-IRA Plan covering substantially all employees. Employer contributions for the years ended December 31, 2005 and 2004 were \$97,180 and \$82,014, respectively. The Company incurred no plan administrative expenses during 2005 or 2004.

NOTE 5 Future Minimum Lease Revenue

The Company derives income from commercial space and leased property. Of the noncancellable leases, one lease, described in Note 2, comprises 97 percent of the lease income. The remaining noncancellable leases are related to the rental of commercial space. The following is a schedule of the minimum future rental income on the noncancellable operating leases at December 31, 2005:

December 31, 2006	\$ 12,137,472
2007	12,134,176
2008	12,003,853
2009	11,797,355
2010	11,701,596
Thereafter	51,492,060

NOTE 6 Concentration of Credit Risk

The Company maintains its cash account with RBC Centura Bank. Cash balances are insured by the Federal Deposit Insurance Corporation up to \$100,000. At December 31, 2005 and 2004 the Company has cash balances in excess of the federal insured limit.

NOTES TO FINANCIAL STATEMENTS (continued)

December 31, 2005 and 2004

NOTE 7 Supplemental Cash Flow Statement Information

	2005	2004
Cash paid during the period for income taxes	\$ -	\$ -
Cash paid during the period for interest	\$ 132,613	\$ -
Noncash investing and financing activities:		
Construction costs included in accounts payable	\$ 355,767	\$ 1,367,764
Total cash as reported on the balance sheet:		
Cash and cash equivalents	\$ 1,435,311	\$ 2,515,604
Restricted cash	939	18,594
	\$ 1,436,250	\$ 2,534,198

NOTE 8 Shareholders' Equity - Preferred Stock

The Company is authorized to issue 1,000 shares of preferred stock, \$.01 par value per share, the rights and preferences of which may be set by the Board of Directors in its discretion. Effective March 31, 1998 the Company authorized 250 shares and issued 105 shares of redeemable, non-voting series A preferred stock which require an annual dividend in the amount of \$200.00 per share, payable on March first and September first. The series A preferred shares carried a mandatory redemption date of September 1,2005 if not otherwise redeemed prior to such date. The series A preferred shares were redeemed by the Company on August 17, 2005 at a price of \$2,500.00 per share.

Effective September 6, 2005 the Company authorized 250 shares and issued 121 shares of redeemable, non-voting series B preferred stock which require an annual dividend in the amount of \$200.00 per share, payable on February fifteenth and August fifteenth. The series B preferred shares carry a mandatory redemption date of August 15, 2012 at a price of \$2,500.00 if not otherwise redeemed prior to such date. If redeemed within two years following issuance the redemption price will be increased by \$200.00 per share. These shares are disclosed in accordance with Financial Accounting Standard 150 in the account titled shares subject to mandatory redemption.

